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40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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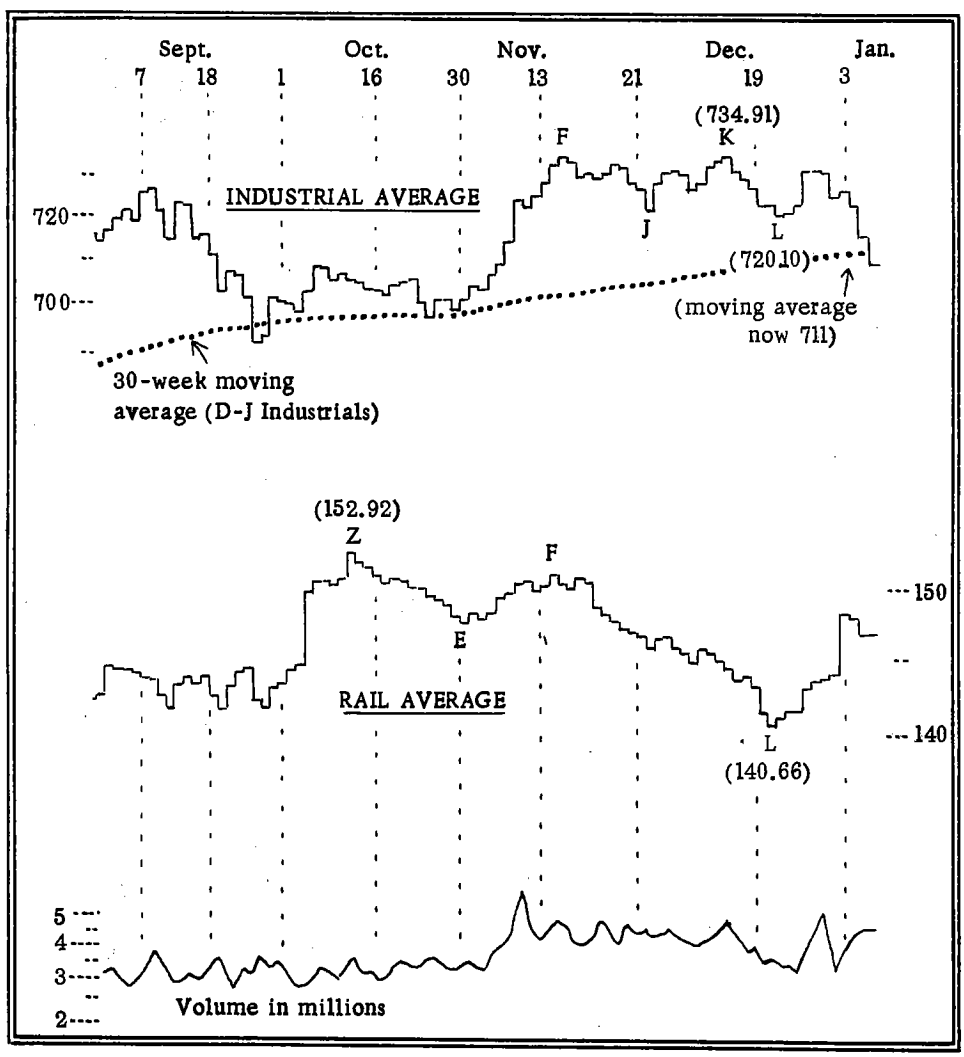
Registered with the Securities and Exchange Commission

THE MARKET - REVIEW AND COMMENT Since February, 1961, the Rail Average has not sold higher than 152.92 nor lower than 133.49. This represents a rather restricted range of approximately 14% in over a year (despite recent improvement in both the general economy and the fundamental "outlook" for the carriers themselves). Since mid-May, 1961, the Industrial Average has not sold lower than 679.30 nor higher than 734.91. This represents an extremely narrow range of approximately 8% in eight months (despite almost unanimous forecasts for a sharp increase in corporate profits during the year 1962).

Letter 165 reviewed the strange (and frustrating) series of movements that characterized the path of the market during 1961. "What we do know", stated Letter 165, "is that for over half a year the Averages have plotted a generally sideways pattern, and such action bespeaks a market that has something on its mind".

On January 5 (Friday) the first significant signs of weakness appeared. To the tune of 4.6 million shares, Industrials dropped 7.69 points while Rails sank 1.34 points. This represented the first high volume penetration of a preceding Industrial point since October, 1960. The decline took Industrials well below their preceding 720.10 (L) closing and obviously shattered the sideways structure which had been in the process of forming since early November. The move also put Industrials within easy striking distance (4 points) of their long-term (30-week) moving average (see chart). It is worth noting that on the only two previous penetrations of the moving average since October, 1961, volume contracted, the downside momentum of the Industrials subsided, and the senior Average promptly recovered. These two minor penetrations of the moving average can be seen on the chart in the September and October area. On Monday (January 8) broad weakness again hit the market, and as of this writing (January 8, 2 P.M. New York time), Industrials have dropped over 12 points, which means that they have sunk well below their moving Average on heavy volume. This would suggest that the market is in more trouble than has been seen at any time since the July, 1961 lows. A further proof of weakness would be a continuing tendency (from this point on) for the Industrial Average to stay below its moving Average. Such action has not been seen since the entire rise began in October, 1960.



It is notable that for almost a year the two Averages have been unable to remain "in gear", either on the upside or the downside. Since March, 1961, we have not seen an instance where the two Averages have either risen to new highs together or dropped to new lows together. The action of January 5 and 8 does not change the state of affairs. Paradoxically, although Rails have been the weaker Average for over three months, it was the Industrial Average

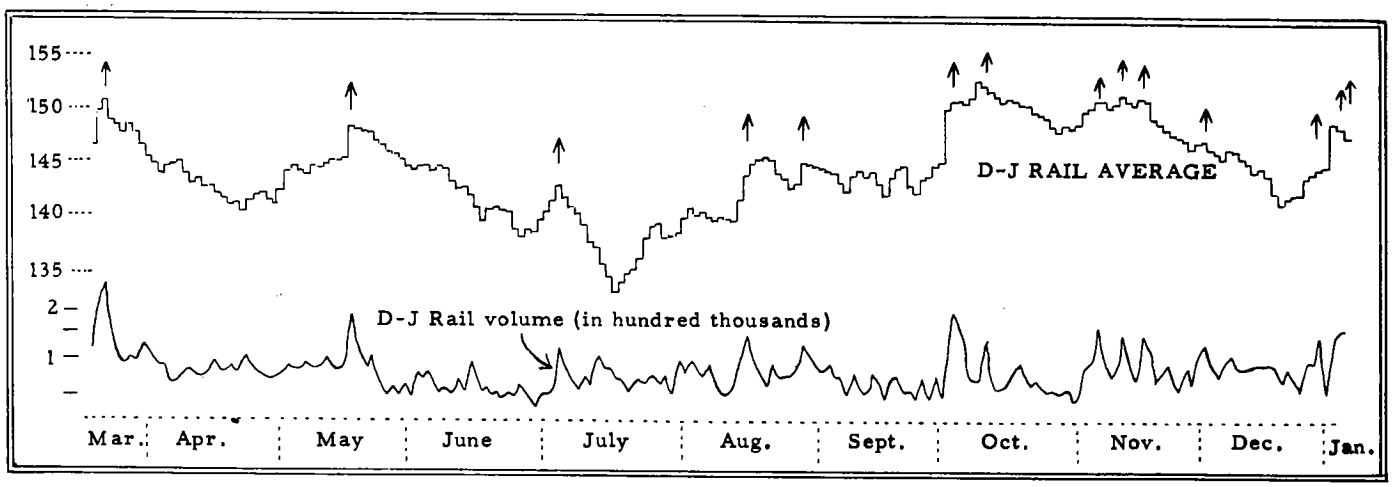
that suffered the real damage on those two days. Should the downside market action continue, an important confirmation of weakness would be a Rail penetration of the 140.66 low point (established December 20 -- see chart). Conversely, a persistent refusal by Rails to drop to a new low (below L) would be the first hint of an impending reversal. The next significant Industrial point is the September, 1961 low of 691.86. A violation of that level would put Industrials in position to "test" the important July low of 679.30.

CONCLUSION: The primary trend or great tidal force of the market is taken to remain bullish. The Industrial penetration of January 5 constitutes a belated confirmation of earlier Rail weakness. The price structure and volume indications suggest strongly that the secondary trend is now down. Dull volume on forthcoming rallies and an inability of Industrials to rise above their moving average (711) will suggest the continuance of a bearish secondary trend.

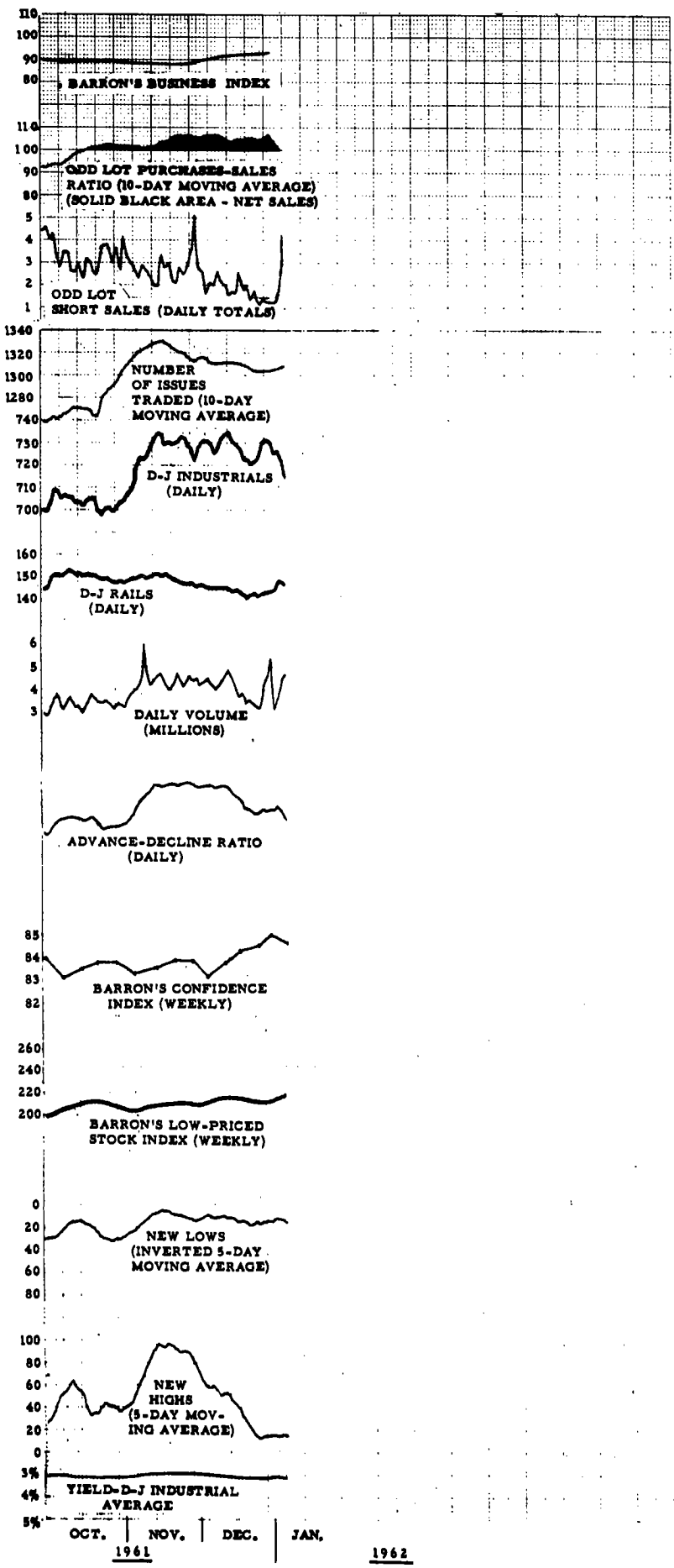
RAIL VOLUME "The charts are excellent", runs the old market adage; "it is the chartists who make the errors". Back in Letter 150 (July 19, 1961) subscribers received a study of volume in the D-J Rail Average. The study called attention to periodic areas of abnormally high Rail volume that have appeared since mid-1959 (Rail volume is listed daily in the Wall Street Journal). This volume seemed to have a definite bearing on subsequent Rail prices, and the conclusion put forth in Letter 150 was as follows: "Sharply higher prices for Rails over the last two years have been accompanied by a day to a few days of abnormally high Rail volume. Whenever this volume has appeared, the Rail Average has subsequently declined. The conclusion is that the Rail Average has been under distribution for the past two years, and that the heaviest Rail selling has taken place under the guise of periodic 'strong' Rail markets".

The accompanying chart shows the movements of the Rail Average together with Rail volume from March, 1961, to the present. The arrows above the Rail price indicate areas of unusually high Rail volume (70-90 thousand shares may be considered "normal" daily Rail volume). The chart shows seven general areas of high Rail volume, and each area was followed by lower Rail prices. Because of the strong formation which appeared in the Rail Average during October and November, I disregarded the accompanying heavy Rail volume. Nevertheless, the same old pattern continued, and following the October and November Rail peaks, the carriers again declined. By December 20, the Rails had lost slightly better than 50% of their entire gains since July, 1961.

During the most recent Rail rally from the 140.66 low of December 20, Rail volume again flared. On December 29, January 3 and January 4, Rail volume rose to 144, 139 and 155 thousand shares respectively. If the pattern which has existed since 1959 continues, we cannot discount the possibility that the Rails are still under subtle distribution, and that the recent Rail rally will be followed by importantly lower Rail prices.



NEW SECTION This writer, through articles in Barron's and through these Letters, was one of the first to draw wide attention to the technical indicators. Over the past few years, I have received an increasing number of requests from subscribers for a periodic tabulation of these indicators. With this issue, I am inaugurating a policy of publishing a chart of twelve indicators, all of which should be of help in gauging the course of the economy and the market. The chart will be brought up to date in that Letter nearest to the first of each month.



Of particular interest (see chart) at this time is the solid black area showing a section of the odd lot selling which actually prevailed during most of 1961. There is a strong seasonal influence at the start of each new year towards odd lot buying (reinvestment), so that the current trend towards odd lot buying cannot be taken as particularly significant at this time. Of interest also is the rising trend of Barron's Confidence Index. The new high index is significant at this time in conjunction with the sagging advance-decline ratio. Both of these indicators suggest a market which is hesitant and selective, but the low level of the new low index does not yet suggest important technical weakness (the new low index, however, should be watched closely on any forthcoming decline). On the most recent market weakness, odd lot short sales expanded very rapidly to January 5th's total of 4.4 thousand shares. In general, when odd lot short sales jump above 5 thousand shares per day, the market is generating too much bearishness and a rally should not be far off. The yield on the D-J Industrial Average is again in the 3% zone, a level which has, in the past, been accompanied by distribution in many stocks (historically, the 3% zone is the danger area for common stock).

Individual indicators will be discussed and explained in detail in these Letters (as before), particularly when I feel that one or the other indicator is saying something of importance.

It is hoped that these monthly chart studies will enhance the value of these Letters, and that this page will provide readers with a clearer picture of the total technical situation in the market.

LATE NOTES: (The following was written Monday, January 8, after the close). Although Industrials dropped over 12 points inter-day, they bounced back for a loss of about six points. This puts them at 708.98, approximately 2 points below the moving Average. If the current weakness is to be merely of the "shakeout" variety (as was the case in September and October), the senior Average should find support in this area (in the area of the

30-week moving average). During true reactions, the Industrial Average will plunge below the moving average and remain below that level. Therefore, if on the next rally, the Industrials meet resistance in the 711 (moving average) area, then plunge lower on increasing volume, the situation will look a good deal more serious than is the case at this time.

STOCKS In a recent Letter I noted that each market (whether bull or bear) seems to breed certain characteristics of its own. The present market is no exception. A great many technicians now watch both the Averages and the individual stocks. Many of these chartists react in the same way to the same stimuli. The market, perhaps due to the prevalence of technicians, now seems prone to "false" penetrations, and this applies also to the action of individual stocks. I have noted that with increasing frequence, the market or a stock will provide a final false downside penetration prior to an important advance. These false "breaks" would, of course, tend to shake-out the technicians who will sell the stock on the basis of a downside penetration.

It is interesting to note that such a penetration occurred in the Industrial Average in July, just prior to the violent rally to the August peak. One wonders (particularly in view of the Rail's holding at this time), whether the January 5 Industrial penetration will prove to be just another shake-out or the beginning of real trouble.

In the case of individual stocks, I have found long-term trendlines to be a good guide to direction; more so, in fact, than penetrations. Douglas is an example. The stock broke out of a large triangle in January, 1961, rallied strongly, then fell back. The mid-1961 weakness looked "frightening". However, the stock held to the trendline, then rallied to a new high for the move. Another scary series of declines ensued, and as of this writing Douglas has penetrated its September bottom but held exactly on the ascending trendline. If the stock now can consolidate in the 32-34 area, it is possible that it is building up strength for another important rally. At any rate, the "shake-out plus rally" pattern has continued in Douglas for over a year.

General Foods is something else again. This stock has been one of the big movers in the Industrial Average for over four years! This is, in itself, an amazing performance. Over the last few weeks, however, GF has finally cracked a long-term trendline, and I view the stock as finally having turned bearish. This does not preclude another rally, but if GF rallies from this area watch the volume. A drying up of volume following a penetration of an important trendline often precedes the more important downside action. For this reason, many traders will wait for the next rally in GF, and if the rally appears weak (and is accompanied by low volume) they will put out shorts.